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## **OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT**

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**Date Issued:** April 8, 2010

**IBA Report Number:** 10-32

**Audit Committee Docket Date:** April 12, 2010

**Item Number:** # 5

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# **Response to the Securities and Exchange Commission (SEC) Regarding the Third Annual and Final Report of Independent Consultant to the City of San Diego**

## **OVERVIEW**

Stanley Keller (the City's Independent Consultant since January 2007) issued his Third Annual and Final Report to the City on February 24, 2010 in accordance with the Cease-and-Desist Order of the United States Securities and Exchange Commission (SEC) dated November 14, 2006. Mr. Keller presented his Report to the Audit Committee and the City Council on March 8, 2010.

In the interest of developing/sending a unified response to the SEC from the Mayor and City Council, the City Council directed the IBA to review and comment on the Mayor's initial draft response. Additionally, Councilmember DeMaio and Chair Faulconer requested the IBA and City Auditor recommend how the Audit Committee might contract for external expertise on internal controls in keeping with the recommendation the Independent Consultant.

This report provides the IBA's comments on the draft SEC response (attached) and discusses certain proposed amendments. The proposed amendments relate to the timing of an independent internal controls audit, contracting for external expertise on internal controls to assist the Audit Committee and assessing the value of the Five-Year Financial Outlook as a planning tool.

# FISCAL/POLICY DISCUSSION

## Comments on the Initial Draft Response to the SEC

The IBA reviewed the CFO's initial draft response to the SEC and provided comments to the COO and CFO on April 5, 2010. In reviewing the initial draft, the IBA felt that the CFO had adequately responded to most of the Independent Consultant's recommendations; however, in addition to minor changes, we have suggested amendments for certain draft responses. The IBA's recommended changes are shown in a strikeout/underline format in the attached draft from April 5th. Key suggested amendments are discussed below.

## Timing of an Independent Internal Controls Audit

Noting that it is unusual for local government to request an independent external audit of internal controls, the IBA agrees with the Independent Consultant's recommendation that the City commission an integrated internal controls audit in conjunction with the City's annual CAFR audit. This was also a recommendation from the Kroll Report. The Independent Consultant has suggested that the integrated audit be performed in connection with the fiscal year 2011 CAFR audit. The CFO's draft response to the SEC expresses concerns related to the timing of this audit.

In the IBA's review of the City Comptroller's Kroll Remediation Status Report (Report #10-22), we recommended that an independent audit of the City's major internal control processes be conducted over the course of a year beginning in January 2011. Acknowledging that the City's readiness for an integrated internal controls audit in conjunction with the City's fiscal year 2011 CAFR audit was uncertain, our recommendation suggested that internal controls audit findings could be utilized in conjunction with the fiscal year 2011 CAFR audit or the fiscal year 2012 CAFR audit.

In further discussing the likelihood of internal controls readiness with the City Comptroller, the IBA agrees the City should be well prepared for an internal controls audit in order to minimize audit expense and best position the City for a successful audit result. An internal controls audit in conjunction with the fiscal year 2011 CAFR audit 1) may not provide the City Comptroller enough time to test/adjust newly implemented internal controls and 2) may not provide an independent auditor with sufficient internal controls data to perform the requisite testing for an audit. The IBA's suggested amendment to response #5 presents this position.

While it is possible that an independent integrated audit could be performed in conjunction with the fiscal year 2011 CAFR audit, it may be wiser to allow more time for thorough internal control implementation and instead perform the audit in conjunction with the fiscal year 2012 CAFR audit. If directed, the IBA stands ready to assist the City Auditor in the selection of an independent external auditor to perform the recommended internal controls audit.

### Contracting for External Expertise on Internal Controls

The Independent Consultant recommends the Audit Committee provide active and regular oversight of the City's efforts to implement its Internal Controls Over Financial Reporting (ICOFR) process. He further recommends that the Audit Committee would benefit from the assistance provided by an independent consultant with internal controls expertise similar to the way he used McGladrey & Pullen to assist with his monitoring efforts. Finally, he suggests that there may be efficiencies associated with the Audit Committee also using McGladrey & Pullen.

In the draft response to recommendation #8, the CFO correctly notes that the Audit Committee continues to perform its oversight responsibilities with respect to the ICOFR implementation process. The Audit Committee regularly requests and receives ICOFR progress updates from the City Comptroller. Additionally, the Audit Committee has benefitted from Independent Consultant commentary derived from McGladrey & Pullen and has received periodic information from the City Auditor on certain internal control processes.

The Audit Committee currently maintains an as-needed contract with the consulting firm of Jefferson Wells. This contract results from a competitive selection process conducted in 2007. Jefferson Wells is a professional service firm with expertise in internal controls and is appropriately suited to assist the Audit Committee when needed. McGladrey & Pullen has provided, and may continue to provide, assistance to the City Comptroller with ICOFR implementation. Given this circumstance and the existing contract with Jefferson Wells, the IBA's suggested amendment to this response recommends the Audit Committee use Jefferson Wells as needed to capably assist them with oversight responsibilities related to the ICOFR implementation process.

### Assessing the Value of the Five-Year Financial Outlook as a Planning Tool

Recommendation #22 states the City should assess the value of its current Five-Year Financial Outlook as a planning tool and consider the use of additional planning tools to meet its goals for the provision of public services. The IBA's suggested amendment to this response notes that the Outlook is updated, revised and issued annually to reflect the most current revenue and expenditure projections and programmatic budget issues. We mention the IBA's independent review/analysis of the Outlook for completeness and accuracy. Additionally, we mention recent amendments to the Budget Policy related to the Outlook and the adoption of eleven Structural Budget Deficit Elimination Guiding Principles. The suggested amendment further indicates the City will continue to evaluate the usefulness of the Outlook while also looking for additional tools to enhance fiscal performance and decision making.

### Fulfillment of the City's Obligation Under the SEC Order

The Office of the City Attorney has provided their position regarding the City's compliance with the requirements of the Cease-and-Desist Order of the SEC. The IBA had previously commented on this topic in Report #10-19. We concur with the City Attorney's position and have inserted their comments at the end of the draft response to the SEC.

## CONCLUSION

The Audit Committee will review the draft response to the SEC regarding the City's actions relating to recommendations received from the Independent Consultant in his Third Annual and Final Report. The IBA has attached suggested amendments to the initial draft SEC response provided by the CFO. We have shared our suggested amendments with the COO/CFO and believe the Mayor will be supportive of these changes in the interest of sending a unified response to the SEC from the Mayor and City Council. Once the Audit Committee has provided their comments related to the attached draft response, the response will be further amended if necessary and forwarded to the City Council for consideration.

**[SIGNED]**

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Jeff Kavar  
Fiscal & Policy Analyst

**[SIGNED]**

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APPROVED: Andrea Tevlin  
Independent Budget Analyst

Attachments: 1) Draft Response to the SEC with IBA's Suggested Amendments  
2) SDCERS letter from Mark Hovey to City Comptroller dated March 3, 2010